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Supreme Court of the United States

OCTOBER TERM, 1928.

NO. 131.

THE ST. LOUIS & O'FALLON RAILWAY COMPANY, and MANUFACTURERS' RY. CO.,

Appellants,

vs.

THE UNITED STATES OF AMERICA, and THE INTERSTATE COMMERCE COMMISSION,

Appellees.

NO. 132.

THE UNITED STATES OF AMERICA, and THE INTERSTATE COMMERCE COMMISSION,

Appellants,

vs.

THE ST. LOUIS & O'FALLON RAILWAY COMPANY, and MANUFACTURERS' RY. CO.,

Appellees.

Appeal from the District Court of the United States for the Eastern Division of the Eastern Judicial District of Missouri.

BRIEF ON BEHALF OF GREAT NORTHERN RAILWAY COMPANY, BY F. G. DORETY AND FLETCHER ROCKWOOD AS AMICI CURIAE.

F. G. DORETY,
FLETCHER ROCKWOOD,
Solicitors for Great Northern Railway Company, as Amici Curiae,
St. Paul, Minn.

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The order of the Interstate Commerce Commission, hereinafter referred to as the Commission, of which cancellation is

sought, and the decision of the lower Court, are fully described and referred to in the Brief for Appellant Railway Companies and so will not be referred to further here. We likewise adopt appellants' statement as to the facts of the case.

It appears from the Commission's report, as pointed out on pages 52 to 63, inclusive of the Brief for Appellant Railway Companies, that the Commission's valuation of the O'Fallon in this case was based upon an estimate of the prudent investment in the property, and that current construction costs were ignored. A brief has been filed herein as amicus curiae by Mr. Donald R. Richberg, as attorney for the National Conference on Valuation of American Railroads, (hereinafter referred to as the Conference) in defense of the Commission's method of valuation. This brief is offered primarily in reply to the brief of the Conference.

The theoretical defense of reproduction cost as the dominant factor in value is usually based upon the principle announced in *Standard Oil Co. of New Jersey v. Southern Pacific Co.*, 268 U. S. 146, to the effect that the value of any property taken or destroyed is to be computed, in cases where there is no established market value, at what it would cost the owner to replace the property, at least in cases where the property would be worth replacing at the time and place of the taking. Counsel for the Conference seems to argue that a railroad is not necessarily worth replacing at its present reproduction cost, merely because it has been earning a good return on such cost under its existing rates. He argues that these rates are subject to reduction by the Commission to a level which would be sufficient to pay a return upon no more than the value which is found in this case, and he would seem to conclude that the Commission is, therefore, justified in finding that the property

would not be worth replacing at any sum in excess of the value so found. He would first determine the lower limit of the Commission's power to reduce rates and would then predicate a resultant value upon such a rate level. He argues that the lowest level of rates (and of value upon which such rates are to be predicated) permissible under the "Due Process" clause is that which will still permit the securing of additional capital for the maintenance of adequate service in the railroad industry, and that to which rates might be forced by competition as free as in unregulated industry.

Without discussing the soundness of this line of reasoning or the propriety of this suggested method of valuation, we desire to point out that if the premises be accepted as sound and proper, and if they be applied logically to the facts, the result will be to fix the lowest proper level of rates at the current cost of duplicating the service, including a return at the going rate upon the current cost of constructing a new plant capable of rendering the same service. Competition could not on the average and in the long run, enforce a lower basis of rates than this, and no lower basis of rates would be sufficient to attract the new capital necessary for the maintenance of adequate service. Instead of leaving the Commission practically unrestricted in its power to reduce rates, as Mr. Richberg argues, and, therefore, free to adopt original cost, 1914 construction costs, reproduction cost, or any factor that happens to be the lowest at the time, as the dominant factor in value, the reasoning of counsel for the Conference would logically establish current construction costs as the dominant factor.

In order to support his contention that the rate base adopted by the Commission for other railways, as well as for the O'Fallon, is sufficient to attract the necessary capital into the railroad industry, counsel points out that actually existing rates

during the last few years have been less than sufficient to pay a return, even on the Commission's rate base, and that notwithstanding this fact new capital has continued to flow into the industry in large volume. This he regards as a demonstration of his contention that the Commission's rate base will continue to attract all necessary capital and that it is, therefore, not so unreasonably low as to violate the "Due Process" clause.

This argument is easily susceptible to a *reductio ad absurdum*. Capital already invested in the railroad industry might be denied any return whatever; the rate base for existing property might be reduced to zero; and yet if rates were made sufficient to pay operating expenses and taxes on the existing plant, plus an adequate return on the *new capital* required, the existing owners could secure that new capital, by subordinating their own interest to that of the purchasers of the new securities. If one hundred million dollars of new capital is required, and existing rates will pay bare operating expenses and taxes, plus an assured 6 per cent on only the new hundred million dollars required, with nothing for a return on existing capital, it should be possible to market one hundred million dollars worth of bonds, provided they are given precedence and made a primary lien upon the entire property and income. It would not be necessary to allow anything whatever for a return on the capital already invested, except perhaps as a margin of safety for the return on the new capital. The argument of the conference would demonstrate that a valuation of zero for existing property would fulfill Constitutional requirements.

The supposititious case just stated is an extreme one, but as a matter of fact it fairly illustrates the actual method by which new railroad capital has been obtained during the last ten years. Mr. Richberg relies upon judicial notice and the public records of the Commission to support his contention that

new capital has been flowing into the railroad industry. The same sources of information will indicate that this new capital has been obtained almost wholly by sale of bonds.

Statement No. 20 on page XXXIV in the Annual Report of the Interstate Commerce Commission on the Statistics of Railways in the United States for the year 1919 and statement No. 21 on page XXXVI of the report for 1926 (1926 being the last year for which report is available) indicate that between 1919 and 1926, the amount of United States railroad stock outstanding in the hands of the public increased only $53,393,218, while the amount of bonds (unmatured funded debt) increased by $1,630,607,736. These figures would indicate that of the total new capital secured from the public during these years, 96.8 per cent was obtained by sale of bonds and only 3.2 per cent by sale of stock. In order to raise this capital the stockholders have been compelled to subordinate their interests and to give precedence to the new investors. The stockholders' return has not been reduced to zero, but it has been reduced far below a normal rate, and might have been reduced much farther without depriving them of the ability to market bonds. Therefore, this continued supply of new capital gives no indication whatever that the return on previously invested capital has been adequate, and it affords no support for the contention that the "Due Process" clause has not been violated by the existing rate level, or that existing rates have not been unreasonably low or confiscatory. Such a conclusion would find support only where new capital had been obtained *on a parity with existing capital*, that is, upon securities having no greater rights of priority. The conclusion would be justified only if it could be shown that new capital had been freely obtainable by sale of stocks as well as bonds. This is contrary to the fact.

The fact that the existing owners are willing to and do subordinate their prior investments for the greater security of the new capital, does not indicate that their existing return is adequate or satisfactory to them. What significance should be attached to the willingness of the existing owners to obtain capital in this way, depends upon the purposes for which the new capital is to be used. A million dollars spent for larger locomotives capable of hauling heavier trains may result in an annual saving of operating expenses equal to ten per cent or more on the cost of the locomotives. Under these circumstances the owners of the property would be well warranted in subordinating their existing interests to a new bond issue of a million dollars at five per cent. Even though earning an entirely inadequate return under existing rates, the company would show good judgment in borrowing the new capital to be expended in securing improved efficiency, thereby reducing operating expenses sufficiently to pay the increased interest charges, and, leaving some little added return for the prior owners. Therefore, the obtaining of new capital for investments which will reduce operating expenses is not as indicative of the sufficiency of existing rates as might be the obtaining of capital for new construction.

There are cases in which the existing owners might be justified in subordinating their interests for the obtaining of capital, even for new construction, notwithstanding the fact that existing rates might be insufficient to yield an adequate or any return on the existing investment. A short branch line tapping a heavy traffic producing district and feeding a large volume of traffic for a long haul over the main line, would increase volume on the main line without correspondingly increasing overhead expenses, taxes or maintenance of way costs. Main line rates which were inadequate for the existing volume of

traffic would tend to become less inadequate when applied to the increased volume of main line traffic, and the additional main line profits thus obtained, might be sufficient to pay the interest charges on the cost of constructing the branch line and still leave something for the original owners. In such a case the owners would be justified in obtaining new capital for the branch line construction by subordinating their own interests to those of the new bondholders, even though the branch line could not be made to pay under existing rates as an independent operation, and even though existing rates were yielding an inadequate return, or perhaps no return whatever, upon capital already invested.

Existing owners might be justified in subordinating their present interests in this way, even though nothing were added to the rate base for the cost of the improved facility or of the new construction and even though already inadequate rates were not to be increased at all as a result of the increased investment. The reduction in operating expenses, or the increase in main line traffic density might be sufficient in themselves to increase the total net return under existing rates, without any increase whatever in rates or in the rate base, and no matter how inadequate existing rates might be. Therefore, the fact that new capital can be obtained by bond issues, and that it is in fact obtained for improvements resulting in reduced operating expenses or for extensions resulting in increased main line traffic density has no tendency whatever to indicate that existing rate levels are adequate or reasonable or that the "Due Process" clause has not been violated.

These illustrations make it clear that, insofar as the ability to obtain new capital is a test, sufficiency of the rate base or valuation of existing railroads and the sufficiency of existing rate levels can be determined or tested only by considering the

availability of capital for the construction of new lines which must be dependent upon the earnings of their own traffic for their support. It is easy to demonstrate that such lines can be constructed only when existing rates are sufficient to pay a return on present construction costs. An 80-cent rate may be sufficient to pay a fair return on the number of dollars invested in a railroad constructed before the war, while a rate of nothing less than a dollar would be sufficient to pay the same return on a newly constructed competing road. Under such circumstances it is futile to establish a higher rate base for the new road, or to "permit" the new road to charge a dollar rate, while reducing the old road to a lower rate base and while compelling the older competing company to charge only 80 cents. The prospective investors in the new road would know, before they started, that they would have to meet the 80 cent rate, and that their investment would necessarily be unprofitable. The new road would not be built under these circumstances. It is obvious that if new capital is to be freely available for the independent construction of competitive lines of railroad, the rate level on existing lines cannot be fixed below a level sufficient to pay a return on present existing construction costs.

According to Interstate Commerce Commission reports, from 1919 to 1926, and through 1927, there was not enough new railroad construction in the United States to offset abandonments and retirements. There were 253,152 miles of road owned on December 31, 1919, and only 249,131 miles on December 31, 1927, a net decrease of 4,021 miles. The new capital obtained during this period, largely on bonds, went into additions and improvements other than new mileage. This is in contrast with the years from 1900 to 1915, when railway rates were more nearly related to current construction costs, and when mileage

increased by 60,848 miles, or an average of over 4,000 miles a year. The fact that new construction has ceased, that railway stock has not been sold, and that new capital has been obtainable only by the sale of bonds, indicates anything but a healthy or adequate rate of return during the period since Federal Control.

It is a fundamental fallacy in the conclusions of Counsel for the Conference, that he assumes that the supply of *new* capital is governed by the return allowed to capital *already invested*. What the new investor is interested in is the return that will accrue to him upon his new capital. If that will be adequate, it is immaterial that the existing investor may be receiving nothing. On the other hand, if the return to the new investor will be inadequate and will afford an inadequate return on the amount of capital that he is required to furnish, not even a very excessive return upon capital already invested will induce new investment. The vital test in all cases is, what return will existing rates pay, not on the capital already invested, but on the new capital that is desired. The question must be, are existing rates high enough so that a new road could meet them in competition, and still pay a return on its own present construction costs. What return present rates are or are not paying on capital already invested in the old road is entirely immaterial. Therefore, the lowest level to which rates can be reduced downward, and still make it possible to obtain capital for new railroad construction—and, therefore, the lowest level permissible under the "Due Process" clause, according to the reasoning of Counsel for the Conference—is a level sufficient to pay a return on the present cost of a new railroad.

The suggestion has been made that this test for a minimum rate level would have been pertinent during the period of active

railroad construction in this country, but that it is not applicable to present economic and transportation conditions, because new construction is being undertaken, if at all, not in the form of independent projects by new companies, but in the form of extensions of or additions to existing systems. It is argued that existing systems with their established credit can obtain all of the capital that is required for new construction, so long as the full actual cost of the new construction is added to the rate base of the existing line. It is said that if existing rates were adequate to pay a fair return upon a 1914 rate base, such a return would maintain existing securities at par, and if the full current cost of new construction is added to this rate base, so that future rates would pay a return upon the 1914 present rate base, plus the actual cost of all additions, the result would be that both present and future securities would be marketed and maintained at par. The conclusion is drawn from this reasoning that a 1914 rate base for existing properties, with increases equal to the actual cost of future improvements and extensions, should be sufficient to insure an adequate supply of capital in the future, even for new construction that must be self-supporting, and without subordinating existing securities to the new ones.

This argument is unsound for two reasons. In the first place, under this plan, it is assumed that an existing road, desiring to engage in extensive new construction, and requiring a large amount of additional capital, could add the actual cost of the new construction to its rate base, and could increase its rates, if necessary, sufficient to pay a return upon its enlarged rate base. This would be true if competing roads were engaging in similar new construction at the same time and to the same extent, and were correspondingly increasing their rate bases and their rates. Otherwise, it would not be true, because one

competitive road would not be in a position to engage in new construction, requiring an increase in its rates, while rates on competing roads remained at the original level. In order to carry out the proposed plan, it would be necessary that all competing roads continue to maintain about the same proportion of 1914 construction costs and of higher post-war construction costs in their physical structures and rate bases at all times. An existing road which desired to undertake new construction to a larger extent than its competitors, would face the same difficulties that would be faced by a brand new company. It might be "permitted" to charge rates high enough to justify the new construction, but competition would prevent its collecting such rates. It could, therefore, obtain the new capital only by subordinating its existing securities, and it would be warranted in doing so only where the result would be a decrease in operating expenses or an increase in traffic density on its existing lines. New construction which must be self-supporting would not be feasible, even by existing roads, except to the extent that competing roads might undertake new construction to the same extent and at the same time. It cannot be said that a legislative policy which would thus restrict and hamper the expansion of a necessary industry is reasonable, or that it would be "due process" within the meaning of the Constitution.

In the second place, even if it could be assumed that new construction would be undertaken by all competing roads to the same extent and at the same time, and that the necessary expansion could be brought about in this way, and even though the new capital could thus be obtained by issuing new securities on a parity with existing securities, it would be "parity" only in name because this program would still involve a sacrifice of their property interests by existing owners, in order to obtain

new capital. The mere fact that new stock is issued on an equality with old does not show that there is no sacrifice on the part of the old stockholders, because the existing property may be under-capitalized. Let us suppose, for example, that a road which would cost $10,000,000 to reproduce and which actually cost $5,000,000 prior to 1914, is capitalized with only a million dollars worth of stock, the balance of the construction cost having been met from earnings, donations or other sources. The rate base of this railroad could be reduced to as low as a million dollars, the amount of the existing outstanding capitalization, and such a company would still be able to market another million dollars' worth of stock at par for improvements, provided it were assured that the additional million dollars would be added to the existing rate base and that future rates would be sufficient to pay a return upon the existing rate base of a million dollars plus the additional million to be expended. But while the old stock might appear to be in every way equal to the new in such a case, it would, nevertheless, be true that the existing stockholders would be selling out a half interest in a five or ten million dollar property for a million dollars. While the company would apparently be obtaining new capital by issuing securities on a parity with existing securities, it would really be making a heavy sacrifice of its existing property interest in order to obtain the capital.

As a general thing, the outstanding securities of existing railroads do not exceed their 1914 construction costs, and as long as a fair return is earned on the par value of securities actually outstanding, (or in other words, on 1914 construction costs) plus the actual amount of any new capital to be added, it should be possible to market new securities on a parity with the old ones. But as we have just seen, this would involve a sacrifice of existing property interests of the old security own-

ers, if the property is in fact under-capitalized. If it be a fact, as we claim it is, that those existing properties which would be worth replacing, are worth their current reproduction costs, and if their outstanding securities amount to no more than their 1914 construction costs, they are in fact under-capitalized today, and a sale of new stock on a parity with the old would necessarily involve a sacrifice by the existing owners. It would be equivalent to selling property with a 1929 value, at 1914 prices. To assume that there is no such sacrifice because the new stock is issued on a parity with the old is to assume that the 1914 construction costs represent the fair value of the property, and that would be, of course, begging the question in issue here. To prove that under a 1914 rate base, new stock could be issued at par today on a parity with old stock would not be to prove that capital is available without confiscation of existing property interests, because it assumes but does not prove that the fair value of existing property interests is no greater than 1914 construction costs.

On the contrary, it is apparent that under such a program of financing, there would necessarily be some sacrifice of existing physical property interests by the existing owners. If existing stockholders own 100 miles of railroad which cost them a million dollars in 1914, and which is represented by a million dollars worth of stock, they might raise an additional million dollars by sale of new stock in 1929. But this new million dollars will at this time build only 50 additional miles of road, at the higher construction costs now in effect. Therefore, the original group of stockholders, who formerly owned the equivalent of one hundred miles of physical railroad, will now own only the equivalent of one-half of 150 miles, or 75 miles. The original stockholders will have sacrificed the equivalent of 25 miles of railroad in order to raise the additional capital. If, at sometime in the future, construction costs should again

recede to the 1914 level, and rates should be forced down to a corresponding basis, the original group of stockholders would find themselves enjoying earnings at the 1914 rate from only 75 miles of road instead of from the original 100 miles which they paid for. The original stockholders are not maintaining their parity with the new ones, unless the physical property which they contribute to the enlarged road is placed on a parity, mile for mile and item for item with the extensions paid for by new capital. This result could be accomplished only if the existing property goes into the enlarged rate base, just as the new construction does, at its full current reproduction cost. Rates on existing property must be sufficient to pay a return on what would be the present reproduction costs of that property before it will be possible for the existing company to obtain new capital without some sacrifice of its existing property interests. Therefore, a downward restriction of rates by the Commission or by the Legislature, in the year 1928, to a point just sufficient to pay a return on 1914 construction costs, falls below the lowest level at which new capital could be obtainable for new construction or for improvements which are dependent upon such rates for attracting the new capital, and without a subordination or sacrifice of existing property interests.

It follows that even if we are to forego entirely the possibility of new construction by independent companies, and to depend entirely upon strong existing companies for all new construction required, the necessary capital for the construction of new lines which must depend upon their own earnings and traffic, will not be available while existing lines are held to a 1914 rate base, except (1) by compelling existing owners to sacrifice or subordinate a part of their existing property rights, and (2) by restricting each existing line to new construction to approximately the same extent and at approximately the same

periods at which similar new construction may be undertaken by other competing lines, so that all lines will continue to have approximately the same proportion of high cost construction in their rate bases. We submit that this would not be a reasonable restriction to impose upon existing lines, and that any rate base or rate level which would impose such a restriction is, therefore, not due process of law. If the rate level adopted by the Commission is to be considered "due process" merely because it admits of the obtaining of new capital upon these conditions, then by the same reasoning any lower rate level or rate base, even down to zero, might be considered as "due process," because it would still permit of the obtaining of additional capital under the same conditions.

The obtaining of new capital for the railway industry is subject to the same fundamental economic laws as is the obtaining of new capital for factories, apartment houses or other industries. The current price of the product must be sufficient to pay the going rate of return upon the cost of building a new plant before new capital can become available for building new plants. Apartment house rentals must be sufficient to pay a return upon the present cost of building an apartment house before new apartment houses will be built. The price of shoes must be sufficient to pay a return upon the present cost of a new factory before new factories will be built. This is as true of railroads as of any other plants.

It is true that there are exceptions to this rule in all industries. Even though apartment rentals are far below the level necessary to attract new capital for new building, the owner of an existing apartment building can always mortgage his property and secure capital to a limited extent in that way, and he may be justified in doing so if he can thereby reduce his operating expenses or secure tenants for his unused apart-

ments. No matter how low the price of shoes may fall, so long as it remains above the bare operating cost of production, the owner of an existing shoe factory can always obtain a limited amount of additional capital by similar means and for similar purposes. And so it is in the railroad industry. New capital can be obtained for improvements which will more than correspondingly reduce operating expenses or which will more than correspondingly increase main line traffic density, and the owners of the existing plant are warranted in subordinating their existing securities to the securities issued to new investors for these purposes. No matter how low the existing rate base may be, even though it be reduced to zero, this will continue to be true. So long as any return at all is allowed, the existing owners can obtain new capital by selling an interest in the existing property at a sacrifice. But these are all exceptional circumstances. The obtaining of capital for new construction which must be self-supporting, requires that rates on existing competing lines be sufficient to pay a return on present construction costs of the proposed new line, and this is as true in the railroad industry as in any other. Therefore, even though we follow Counsel for the Conference in his main line of reasoning to the conclusion that the minimum rate level is a level that is just sufficient to insure an adequate supply of new capital, we must reach the further conclusion that present construction costs must be the dominant factor in the rate base.

In his dissenting opinion to the report of the Commission which is under review (124 I. C. C. 3, at 56), Mr. Commissioner Eastman meets the difficulty which we are raising here by suggesting that the continued construction of new railroads could be brought about under high construction costs, notwithstanding that competitive rates might be based upon lower construction costs on other railroads, by donations from the Government to the new company to cover added construction costs due to

higher wage and material prices, and that it would be economical for the Government to make such donations in order to keep down the general rate level. The same suggestion might be made as to any industry or as to all of them. By making donations toward construction costs of new plants, the Government might stimulate the supply of the product and thereby reduce the selling price throughout the entire industry. No one would contend that it would be sound economics for the Government to thus distort the normal distribution of labor and capital, which would otherwise be governed by the laws of supply and demand. An artificial stimulation of railroad industry would be just as uneconomic as the artificial stimulation of any other industry.

However, it is not necessary to discuss the economics of this suggestion, because the suggestion does not answer the question which we are discussing. The matter in issue is the assertion made by Counsel for the Conference, that the compulsory reduction of railroad rates to an original cost basis is "due process," because it is sufficient to induce the flow of new capital into the industry. We have demonstrated, we believe, that such a rate level would not induce a supply of new capital for construction which must be self-supporting, and upon which the new capital must be entirely dependent. It does not strengthen Counsel's argument to say that the Government could supply the capital, because, of course, the Government can supply capital no matter how confiscatory the existing rate level may be, and because such action by the Government would not tend to relieve it of the charge of confiscation in the fixing of rates on existing railroads.

We might add here that the fact that some railway stocks have been selling substantially above par, has no significance, unless it is shown that the par value of the stock outstanding

is equal to the true value of the railroad operating property, and that the company has no substantial outside assets. It is a well-known fact that in many cases the high price of individual railway stocks is due to the ownership of oil properties or other assets not included in the railroad operating property. And even where this is not so, the railroad operating property may be largely undercapitalized. Any argument based upon high market prices of stock must involve a finding of the true value of the property, and a comparison of it with the capitalization.

The second test suggested by Counsel for the Conference, for the sufficiency of the Commission's rate level is to determine whether the rates are any lower than the level to which free and unregulated competition might reduce prices in unregulated industries. Are they below the prices which might actually prevail in a free market, where neither seller nor buyers have any special advantage in bargaining power? Counsel argues that in a free market, the upper level of prices is a level just sufficient to pay a return upon current construction costs, because at this point new capital will be attracted into the industry, increasing the supply of the product and preventing any further increase in price. This he says is the highest possible level at which prices can be maintained, in a market where the seller has an advantage, and he designates this a "monopoly price." On the other hand, in a market where the buyers have the advantage, he argues that competition may force the price down to a level barely sufficient to pay the operating costs of production. Any level which may be adopted by governmental action between these two extremes is a level to which rates might be forced by unregulated competition, and, therefore, complies with the requirements of "due process."

One fallacy in this argument lies in the fact that what Counsel refers to as the "monopoly price" or "highest pos-

sible price" under free competition, is really the normal or average price, and that competitive prices will tend to fluctuate both above and below this level. If a city is oversupplied with apartment houses, rents will tend to fall below this level. But as population increases and existing apartment houses become filled, rents will tend to rise. No new construction will be attempted, however, until rentals reach a point sufficient to pay a return upon the present cost of new construction. At this point, new construction will commence. But building requires time for completion. The supply will lag behind the demand, and in the meanwhile, rentals may continue to rise to a considerably higher level before the supply overtakes the demand. Even then rents are likely to remain at this higher level until the supply actually exceeds the demand. At this point the downward swing will commence again, and may continue until rentals have fallen to a point where they will no longer pay a return upon new construction. Here new construction will cease until the increase in population and demand, or the retirement of old buildings shall again force them up to and above the level necessary to produce new construction.

The same rule applies in the manufacture of shoes, and in every other industry. Prices will fluctuate above and below the level necessary to attract new capital, but in each case they tend to return toward this level. If they are below, new plants will not be built until the supply is restricted by the retirement of old plants, or demand is increased by greater use of the product, which will force them upward. If prices are above the normal level, corresponding influences tend to force them down. The ultimate tendency is always in the direction of the normal price which Counsel for the Conference designates as the "monopoly price."

The fallacy of using the term "monopoly price" to designate this normal price level will be more apparent if we consider some commodity which really partakes of monopoly characteristics, such as a patented article which is not subject to competitive production. The price of such an article may rise far above a level necessary to pay a return on current construction costs. An article which costs 50¢ to produce may sell for $10. The only limit is "what the traffic will bear." If a patented machine costing $100 to produce will save a thousand dollars a year in labor costs, it may be marketed at a price of several thousand dollars for each machine. The extent to which a "monopoly price" may rise, is limited only by the extent of the desire of the consumer, and it need have no relation whatever to the cost of the plant or the cost of producing the article.

New capital cannot flow into such an industry and force prices down because of the restrictions of the patent laws. The price of the product will not be a competitive price because the production is not subject to competition. This is a true "monopoly price". But what Counsel for the Conference designates as a "monopoly price" is, by the force of his own reasoning, a competitive price. It is the price level at which competition will attract new capital into the industry. By Counsel's own assumption this competition is free to act, and there is, therefore, no monopoly about it.

While railroads are subject to a large extent to competitive influences, they also partake to a considerable extent of monopoly characteristics. An existing railroad may completely occupy a strategic mountain pass or the only feasible entrance to a city. The construction of a new competitive railroad might require the tearing down of existing buildings at large expense. In any event, it would divide the available traffic with the existing road, and rates which might be paying an excessive

return to the existing road, might be inadequate to pay a fair return to either road if the traffic were divided. Consequently, as in the case of prices of a patented article, or other monopolistic commodities, railroad rates, if unrestricted, might rise considerably above the level sufficient to pay a return upon the cost of new construction, before new construction would actually be attempted and before competition would force prices downward. Counsel for the Conference is clearly mistaken in contending that the rate level which the carriers are contending for in this action is a monopoly level, or that it represents the highest price that the carriers could possibly obtain in a free market. Conclusive proof of this lies in the fact that the O'Fallon actually collected rates on a substantially higher level than this during the period for which recapture of earnings is sought.

What Counsel terms the "monopoly rate" is really the normal rate toward which competition would tend to force railroad rates if they were unregulated and if competition were readily available. What is true of apartment houses and shoe factories would then be true of railroads. When rates were paying more than a fair return on current construction costs, new railroads would be built and would force them down. When rates were below this level new roads would not be built and the expansion of business would tend to force the rates up. The tendency, whether upward or downward, would always be in the direction of the normal level which Counsel calls the "monopoly rate."

The public character of railroad service, and the fact that the owners have devoted their property to this public service and have thereby subjected it to governmental regulation, might be advanced as reasons making it lawful and proper for the Legislature to accomplish by regulation, what is accomplished

by competition in unregulated industries, and to prevent the fluctuation of rates upward from the normal level to the monopoly level. It might be argued that it is entirely proper for the Legislature to restrict rates to a level just equal to the cost of duplicating the service, including a return upon the cost of constructing a new plant, because that is no more than what competition would tend to accomplish in a free market. But there can be no logical argument for a lower rate base.

It might be argued that, during periods when the traffic capacity of existing railroads exceeds the traffic demands, so that existing roads would be anxious to secure additional traffic, the tendency under free competition would be to cut rates, and that this might go so far as to reduce them to a level little more than sufficient to pay operating expenses and taxes. Since, during periods when traffic capacity exceeds traffic demands, competition might force rates to this low basis, the government may during the same periods force them down to the same basis. So long as regulation does not force rates to a level lower than competition without regulation would force them, it cannot be said that the regulation is inflicting any damage or that it is taking property without "due process."

If we accept this reasoning we must likewise accept the reasoning that when traffic demands overtake or exceed existing railroad capacity, the law of supply and demand will tend to force rates up to the extreme maximum that the traffic will bear. If regulation is to adopt, at any particular time, the level which competitive conditions at that time might enforce, it must adopt such levels when they would be above the normal as well as when they would be below it. It would not be reasonable or fair, and, therefore, it would not be "due process" for the regulating body to attempt to apply what would be the competitive return whenever the competitive return

would be subnormal, and to refuse to apply it during periods when the competitive return would be abnormally high. If regulation is to follow competitive conditions, it must follow them consistently.

But this would mean that there would be no effective regulation at all. If rates under regulation are always to be fixed at the same point where they would be without regulation, then regulation is accomplishing nothing. It is the true function of regulation to prevent these competitive fluctuations by holding rates to the normal, and the normal rate is found at the point above and below which the competitive fluctuations would occur and toward which they would tend. A system of regulation which would follow competitive forces downward but which would restrict them when tending upward would impose losses upon the carriers during some periods, without giving them corresponding gains during others. It would give all of the advantage to the public and none to the carriers. It would be manifestly unfair, inequitable and uneconomic. It would not be "due process."

Moreover, the very fact that this is a recapture case negatives one of the premises of this argument. As applied to the O'Fallon counsel would have to argue that if there had been no regulation of railroad rates during the recapture period, rates on railways competitive with the O'Fallon would have been much lower, and would have forced the O'Fallon rates down to a basis sufficient to pay a return on no more than the rate base fixed by the Commission in this action. Therefore, it would be argued, it is no hardship on the O'Fallon for the Commission to force its rate base down to the same level by regulation. But the fact that the O'Fallon was able to earn this so-called excess income, during a period when railways in general were earning not even a return on a 1914 rate base

would negative this. The O'Fallon has shown that under the same rates, it is a much larger earner than its competitors. Therefore, it can operate under lower rates than they can and still make a profit. Competitive railways would have to operate under very much lower rates than those which were actually in force, before the rates of the O'Fallon could be forced by competition to the rate level which the Commission has adopted for it. This attempted justification for a low rate base can never be applicable to individual railways like the O'Fallon, which are able to earn greater profits at the same rates, or equal profits at less rates than their competitors.

And even in the case of railways in general, an argument that regulation should during a given period, be permitted to force rates to a low level because the competition existing during that period, would, in the absence of regulation, have forced them just as low, would seem to require some evidence that such competition actually existed, or at least a Commission finding to that effect. It would certainly not be "due process" for the Commission to establish a subnormal rate level at any or at all times, with no other justification than the subsequent argument of counsel to the effect that at the same time or times, then existing competition might have forced the rates to an equally low level without any regulation.

If Counsel for the Conference is to insist that "due process" implies fairness and equity, what fairer standard of fairness could be adopted as between the carrier and the shipper, than the present cost of duplicating the service. The carrier would have small reason to complain if it is held down to rates at which another company would be willing to furnish the service if the carrier had not already occupied the field, or at which the shippers could produce the service for themselves. On the other hand, the shippers could hardly complain, so long as they are

paying the existing carrier no more than it would cost them to produce the service for themselves, and no more than they would have to pay some other company to induce it to enter the field if the existing road were not there. This price at all times would have to include a fair return upon the present cost of constructing the plant.

As stated at the beginning of this brief, we are not discussing the soundness or the propriety of the method suggested by Counsel for the Conference, for finding the value of a railroad, or of his general line of reasoning. We are simply pointing out that if that method and that reasoning be followed to their logical conclusion, it must result in the use of current construction costs as the dominant factor in valuation. And this conclusion conforms to the more generally accepted principles as declared by this Court, that when property is taken or destroyed, the value is the price for which similar property can be procured in the open market, if there is any such market for the particular commodity in question, and that where there is no established market, the value is to be computed at what it would cost the owner to procure or construct a similar or equally good property, assuming, of course, that the property in question is one which would be worth replacing. Standard Oil Co. of New Jersey v. Southern Pacific Co., 268 U. S. 146. If a railroad is serving a necessary or useful public purpose which would warrant its replacement (and the earnings of the O'Fallon demonstrate that it is in this class) then the measure of damages for destroying it or taking it cannot be less than what it would cost the owner to construct an equally serviceable property. If the property itself cannot be taken for less than this amount, it would seem to follow that the service of the property cannot be taken for less than a sum which would pay a fair return on the same amount. It would seem to be

just as improper to take service for less than what it would cost to replace it, as it would be to take tangible property. See McCardle v Indianapolis Water Co., 272 U. S. 400.

We are not setting forth in this brief the argument based upon the varying purchasing power of the dollar, because we believe that that has been ably and effectively presented in the Brief for Appellant Railway Companies. But it may be noted in passing, that that argument leads to the same conclusion which we arrive at when we apply the economic principles which are set forth in the brief of the Conference. To declare by legislative fiat or by Commission order that the value of any property must always remain the same in number of dollars, no matter how the value of the dollar may vary, would be as unreasonable and as arbitrary as it would be to declare by legislation that the value of wheat must always rise or fall with the value of copper.

Counsel for the Conference argues that shippers should not be compelled to pay more than they would have had to pay if the government had entered the field and were furnishing the service. He argues that if in 1914 the government had taken over the railroads at 1914 prices, the capital costs today would still be based upon those prices. But the answer is that if the government had taken over the railroads in 1914, it would then have assumed the risk of a general lowering of construction costs as well as of an increase. At that time no man knew whether construction costs were to go up or down. In addition to paying a 1914 price for the roads, the government would have been compelled to carry an additional burden, by assuming this risk. The owners would not only have received the 1914 prices, but they would have received protection against any decrease in construction costs. With the increase in price level that has actually occurred, the owners could have invested the proceeds

from the sale of their properties to the government in apartment houses, shoe factories or other industries and derived a benefit from the increase in price level.

But to apply 1914 prices today, upon the ground that the government might have invested upon that basis 15 years ago, would be to deprive the owners of this speculative advantage which they would have under competitive conditions in other industries in which they might have invested, and to relieve the government and the public of the speculative burden. The public cannot hold off in 1914, hoping perhaps for a reduction in construction costs, and then, when an increase takes place, claim the benefit of the bargain which it might have made in 1914. If prices are to be fixed today at what it would cost the government to produce the service, the estimate of governmental costs must be made as of today and not as of 1914.

Nor would it be fair to hold private owners to the rate of return at which the government might be able to secure capital. It cannot be argued that because the government could borrow five hundred million dollars at 4 per cent and build a railroad, therefore, the cost of building the railroad is only 4 per cent. The government would be contributing something more than 4 per cent. It would be contributing its credit, and to a certain extent might be weakening its credit. The people as a whole would be burdened for the benefit of the shippers, and this is something that the shippers have no right to demand. The cost of securing capital must be computed at the rate which the shippers themselves would have to pay if unaided by outside credit.

Perhaps the fallacies in the conclusion reached by Counsel for the Conference will be more apparent if we consider the case of a brand new railroad constructed in 1928 at high construction costs, for the purpose of handling a heavy volume of

valuable traffic, which is well able to move freely at rates amply sufficient to pay a fair return upon the entire 1928 construction costs. Counsel would argue that even on this railroad, rates sufficient to pay a return upon present construction costs would be "monopoly rates"; that in a free market, unregulated competition might force rates far below this level; and that, therefore, the Commission, without violating the "due process" clause, could establish a rate base substantially below the actual cost of the property. He denies that either actual construction costs or costs of reproduction would be controlling. There is not an argument in his whole brief which is not just as applicable to a newly finished railroad, built at present costs, as to an old one built at lower costs. And yet, the bare suggestion that the rate base on such a newly completed railroad might be fixed at half its actual cost, and that the government should be entitled to recapture earnings in excess of a return on this reduced rate base, is nothing less than shocking. To force the owners of the new railroad to furnish service at less than its actual cost to them, and to pay deficits in their actual interest charges out of their own pockets in order to increase the profits of shippers who are well able to pay the actual cost of the service which they receive, or for the Government to "recapture" a part of the net earnings which would already be insufficient to meet actual costs of production, would be confiscation of the clearest sort. If Counsel admits that this would be confiscation, then he must brand his entire argument as fallacious, for his argument would justify such a course. If he sticks to his reasoning and insists that such rates would be proper, he makes his argument prove too much. He would justify a situation which would be shockingly unfair and unjust. Clearly, such a newly constructed road must be permitted to charge its actual cost of producing the service, unless and until it can be shown

that some other company could produce it more cheaply. And if this level of rates is the proper level for a road constructed in 1928, it is hard to see why a lower rate could be enforced upon another company for performing the same identical service, with the same number and kind of rails and engines and cars, merely because its road happened to be constructed in 1914. The 1914 road might have been incurring heavy deficits which would entitle its owners, in fairness and equity, to rates as high as or higher than those accorded to the new road. And if reasonableness and "due process" are to govern, it is hard to see why the shippers located on the 1914 road should be accorded lower rates than their competitors located on the new road, for the same identical service. Sound economic principle demands rates for all roads based on current construction costs. To forsake this fundamental principle for artificial formulae is to become entangled in a maze of inconsistencies.

While the argument of Counsel for the Conference is used in the present case to justify a rate base which the Commission arrived at by computing prudent investment, in lieu of a higher reproduction cost, the same argument will be equally applicable in defense of a rate base which might be determined upon the basis of reproduction costs when reproduction costs are lower than prudent investment. During a period which may develop in the future, when the cost of reproduction is below prudent investment, the Commission, in the exercise of its judgment, may establish a rate base from consideration of reproduction cost, and Counsel's argument will be equally applicable to sustain such future action of the Commission. It necessarily follows, if his argument is sound, that the Commission is free to choose either prudent investment or reproduction cost, whichever is lower. There would be practically no judicial or constitutional restriction whatever upon the Commission's

power in this respect. Here again the argument proves too much. It inevitably leads to extreme and even to absurd conclusions.

Counsel for the Conference argues that if current construction costs are to be established, by judicial action, as the dominant factor in the present case, the decision will sterilize the power of the Commission and deprive the Legislature of all power of rate regulation. This is clearly not so. Counsel himself concedes that there is such a thing as a minimum or "cut-throat" price and that it is proper by judicial action to restrain the Legislature from going below this minimum. We are merely suggesting a somewhat higher minimum. As a matter of public policy and in order to encourage construction, the Legislature might fix rates above the minimum, or in the exercise of its discretion, it may reduce them to the minimum. Even if they are reduced to the minimum, it must still exercise the function of distributing the burden between different commodities, fixing higher rates than the average upon some and lower than average rates upon others. And it must still determine what level of rates will produce the largest net return to the carrier, for it does not necessarily follow that higher rates will always produce more profits. Lower rates may increase volume and produce a higher net profit. It would still remain within the authority and the function of the Commission to determine all of these questions. It is unsound to argue, as Counsel for the Conference does, that this court, by declaring that current construction costs must be the dominant factor in the valuation of a going and successful railroad, would thereby deprive the Commission of its power to regulate rates.

There is a vast difference between depriving the Commission of its power to regulate rates and declaring that that power is subject to Constitutional restrictions. The Constitution

clearly declares that neither the property, nor the transportation which it produces, can be taken without "due process." The Commission's action must not be arbitrary or unreasonable. It clearly violates this rule when it compels a railroad company to furnish service at rates lower than the cost which the shippers would have to incur in producing the service for themselves, and lower than any other company would be willing to furnish the service for, if the field were unoccupied. Regulation of an industry becomes unreasonable and arbitrary when it would impose burdens so onerous that new capital could not be induced to enter the industry at all, except by a subordination or sacrifice of the capital already invested. It would be both arbitrary and unreasonable to invoke the power of regulation to impose restrictions which competition imposes in freely competitive industries, and then to draw these restrictions more closely by regulation than competitive forces themselves would draw them. We submit that there is no sound argument which will justify a valuation or a rate base for a going and prosperous railroad at less than the present cost of producing an equally serviceable railroad. Current construction costs must be the dominant factor in the valuation of such a railroad.

Respectfully submitted,

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